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No. 94-18

IN THE

Supreme Court of the United States

OCTOBER TERM, 1994

Antonio C. Mastrobuono and Diana G. Mastrobuono,

Petitioners,

v.

Shearson Lehman Hutton Inc., a corporation, Nick DiMinico, Richard F. Benzer, and Mark Stevenson,

Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

REPLY BRIEF FOR PETITIONERS

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ARGUMENT

I.

THIS CASE PRESENTS AN IDEAL OPPORTUNITY FOR THIS COURT TO RESOLVE ISSUES OF SIGNIFICANT IMPACT OVER WHICH A CLEAR SPLIT OF AUTHORITY AMONG THE CIRCUITS CONTINUES TO DEVELOP.

(Reply to Resp. Br., Pt. I, pp. 1-2).

Respondents assert that because this Court has previously declined review of the issues presented here, it should continue to do so, citing this Court's denial of *certiorari* in *J. Alexander Securities, Inc. v. Mendez,* 17 Cal.App. 4th 1083, 21 Cal.Rptr.2d 826 (Cal.Ct.App. 1993), *cert. denied,* ____ U.S. ____, 114 S.Ct. 2182 (June 6, 1994) (O'Connor, J. and Rehnquist, J., dissenting), and *Lee v. Chica,* 983 F.2d 883 (8th Cir. 1993), *cert. denied,* ____ U.S. ____, 114 S.Ct. 287, 126 L.Ed.2d 237 (October 4, 1993). Significantly, this argument fails to address the fact that in both *Mendez* and

Lee, the lower courts affirmed arbitral awards of punitive damages, and this Court's determination to decline review left those decisions in place. In this case, this Court's decision to decline review would have the opposite effect, and would essentially affirm a decision vacating an arbitral award of punitive damages based on a choice of law provision.

Further, respondents overlook that what has come to pass is precisely the problem predicted by the justices who dissented from the denial of *certiorari* in *Mendez*. As stated by respondents, the decision of the Seventh Circuit in this case had been decided at the time *certiorari* was denied in *Mendez*, and, in fact, was cited by the dissenting justices as part of the growing body of conflicting

decisions compelling the granting of *certiorari*. The decision in *Mendez*, a decision of the California state appellate court, however, did not itself contribute to the split of authority among the federal Courts of Appeal. Accordingly, the granting of *certiorari* in that case, particularly in light to the pendency of this case, would have constituted an attempt to resolve a conflict among the Circuits in the context of a state court case.

Also, when *certiorari* was denied in *Lee*, the decision of the Eighth Circuit in that case was consistent with the prior decisions of the First, Ninth and Eleventh Circuits, with the only contrary decisions having been previously issued by the Second Circuit. As set forth fully in the Petition For Writ Of Certiorari, the

decision of the Seventh Circuit in this case intensifies the split of authority among the Circuits, with a total of six Circuits having addressed the issue and two finding arbitral awards of punitive damages unenforceable in light of choice of law provisions and four having reached the contrary determination and having upheld awards of punitive damages.

Respondents also suggest that the decisions of the First, Second, Seventh, Eighth, Ninth and Eleventh Circuits, as well as the decision of the California Court of Appeal in *Mendez*, "do not reflect significant disparities in their views as to the requirements of the Federal Arbitration Act" but instead merely reflect "varying interpretations of different contractual language." (Resp. Br., p. 1). As discussed *infra* (at pp.

10-14), however, respondents' argument is a fruitless attempt to reconcile patently contrasting and inconsistent decisions with regard to an issue which is not governed by fact-specific considerations related to the particular contract language involved.

II.

PETITIONERS' STATEMENT OF THE FIRST QUESTION PRESENTED FOR THIS COURT'S REVIEW IS CORRECT; THE SEVENTH CIRCUIT'S DECISION CLEARLY SUBORDINATES THE FAA AND THE POLICIES WHICH IT EMBODIES TO NEW YORK STATE LAW, THE LAW OF THE STATE NAMED IN THE CHOICE OF LAW PROVISION CONTAINED IN THE PARTIES' CONTRACT.

(Reply to Resp. Br., Pt. II, pp. 2-3).

Respondents assert that in formulating the first issue presented for this Court's review, petitioners have "significantly misstated the holding of the Seventh Circuit" and that that error "invalidates petitioners' arguments for

review." (Resp. Br., p. 2). In support of this contention, respondents state that the Seventh Circuit's decision expressly acknowledges that the FAA governs and recognizes the liberal federal policy favoring arbitration agreements which requires that all doubts concerning the scope of arbitrable issues be resolved in favor of arbitration. Respondents' contentions, however, ignore the fact that, notwithstanding the Seventh Circuit's superficial acknowledgement of these principles, both the import of its decision, and the analysis used to reach that decision, clearly contravene the FAA and the policies which it embodies in preference to the New York state rule against arbitral awards of punitive damages.

Further, when confronted with the same issue presented in this case, in upholding arbitral awards of punitive damages, the First, Eighth, Ninth and Eleventh Circuits have framed the issue as a question of whether state or federal law applies. For example, in *Todd Shipyards Corp. v. Cunard Line, Ltd.*, 943 F.2d 1056, 1062 (9th Cir. 1991), stated:

> In this case it is clear that federal rules, rather than New York state rules apply. The Supreme Court has said time and time again that issues of arbitrability in cases subject to the act are governed by federal law. *Todd*, 943 F.2d at 1062.

Similarly, in *Lee*, where the arbitration agreement at issue included a Minnesota choice of law provision, the Eighth Circuit stated:

> Even if we accepted as valid [defendant's] argument that under state law the parties did not agree to arbitrate

> punitive damages, it would not be dispositive of this case. This case is governed by federal law. *Lee*, 983 F.2d at 888. [Citations omitted.]

See also *Raytheon v. Automated Business Systems, Inc.*, 882 F.2d 6, 11, n. 5 (1st Cir. 1989); *Bonar v. Dean Witter Reynolds, Inc.*, 835 F.2d 1378, 1387 (11th Cir. 1988). In each of these cases, the Courts of Appeal found that federal law, rather than the law of a state named in a choice of law provision controlled and, in light of that determination, upheld arbitral awards of punitive damages.

Respondents' reliance on the Seventh Circuit's more recent decision in *Baravati v. Josephthal, Lyon & Ross Inc.*, No. 93-3647 (7th Cir., July 1, 1994), as somehow rehabilitating its decision in this case is unavailing. (A copy of the Seventh Circuit's decision in *Baravati* is appended

hereto.) That decision does not purport to overrule the decision in this case but seeks, *ex post facto*, to excuse the Seventh Circuit's refusal to follow and apply the FAA in preference to the law of a state named in a choice of law provision and, unsuccessfully, to reconcile its decision in this case with the FAA and the policies which it embodies. If anything, the Seventh Circuit's *dicta* discussion of *Mastrobuono* in *Baravati*, a case where the arbitration agreement at issue did not contain a choice of law provision, exacerbates the confusion over how the issue of the arbitrability of punitive damages claims should be addressed where arbitration agreements governed by the FAA contain state choice of law provisions which are asserted to implicitly foreclose arbitral awards of punitive damages.

III.

RESPONDENTS' ATTEMPT TO RECONCILE THE DECISION OF THE SEVENTH CIRCUIT IN THIS CASE AND THE DECISION OF THE SECOND CIRCUIT IN *BARBIER*, WITH THE CONTRARY DECISIONS OF THE FIRST, EIGHTH, NINTH AND ELEVENTH CIRCUITS IS UNAVAILING.

In their attempt to obscure the inconsistency of the decisions of the Second and Seventh Circuits with the decisions of the First, Eighth, Ninth and Eleventh Circuits, respondents argue that those decisions do not present "a conflict of legal principle" but rather a matter of different interpretations of different arbitration agreements. (Resp. Br., p. 4). In support of this argument, respondents seek to distinguish the decisions of the First, Eighth, Ninth and Eleventh Circuits on the basis that the arbitration agreements at issue in those cases provided for arbitration under the

rules of the American Arbitration Association.

Contrary to respondents' assertions, the Seventh Circuit itself explicitly acknowledged that its decision in this case conflicts with the decisions of the First, Eighth, Ninth and Eleventh Circuits. (*Mastrobuono v. Shearson, Lehman Hutton, Inc.*, 20 F.3d 713, 718 (7th Cir. 1993); Pet. App., p. 19). Further, respondents' attempts to distinguish this case from those decisions is unavailing, particularly for the reason that the arbitration agreement at issue here does not adopt the AAA rules and that the rules it does refer to "do not contain the empowering language equivalent to the AAA provision." (Resp. Br., p. 5). As the Seventh Circuit acknowledged, the NASD Arbitrator's Manual expressly addresses

the issue of punitive damages, stating, "Parties to arbitration are informed that arbitrators can consider punitive damages as a remedy." In its decision, the Seventh Circuit also noted that the NASD Rules of Fair Practice prohibit any condition that limits the ability of the arbitrators to make any award. Notwithstanding the fact that the NASD rules, like the AAA rules, apparently contemplate the award of punitive damages, the Seventh Circuit concluded that, to the extent that the provisions of the NASD Arbitrator's Manual and the NASD Rules of Fair Practice conflict with New York law, New York law controls.

The Court similarly disregarded the language of the agreement at issue which "does not purport to withhold certain issues from arbitration" but requires

arbitration of all controversies. *Mastrobuono*, 20 F.3d at 718; Pet. App, p. 18. In circumventing this language, the Court created an exception to the federal policy favoring arbitration, stating, "We think the policy favoring arbitrability applies with less force when there are doubts concerning the availability of punitive damages - as opposed to the scope of 'arbitrable issues.'" *Id.*

Given these circumstances, the fact remains, notwithstanding respondents' attempts to discern a basis for distinguishing the Seventh Circuit's decision in this case from the decisions of the First, Eighth, Ninth and Eleventh Circuits, the decisions of the First, Second, Seventh, Eighth, Ninth and Eleventh Circuits are manifestly irreconcilable and the arbitral remedies

available to similarly situated parties who have entered arbitration agreements governed by federal law have come to depend on geographic fortuity. The decisions of those circuits present a clear split of authority on how state choice of law provisions claimed to foreclose arbitral awards of punitive damages are to be read in light of the FAA and federal policy which can only be resolved by this Court.

IV.

THE SEVENTH CIRCUIT CLEARLY ERRED IN ITS DETERMINATION THAT PETITIONERS HAD WAIVED THEIR RIGHT TO PUNITIVE DAMAGES; THE SECOND QUESTION PRESENTED IN THE PETITION FOR WRIT OF *CERTIORARI* IS NOT MERITLESS.

(Reply to Resp. Br., Pt. IV, p. 6).

Respondents misapprehend the second question stated in the Petition For Writ Of *Certiorari*, stating that that question

"appears to be intended to seek review of the Court of Appeals' affirmance of the district court's ruling denying petitioners' request for a trial in the district court to determine punitive damages." (Resp. Br., p. 6). The point raised is that a waiver requires the voluntary relinquishment of a known right, a relinquishment which, simply put, cannot be inferred from a parties' agreement to a contract provision requiring arbitration of all controversies and a choice of law provision. It is petitioners' assertion, consonant with the definition of waiver promulgated by this Court, that they did not waive their right to recover punitive damages, in whatever forum might be appropriate. The Seventh Circuit glossed over this point, apparently finding that "[b]ecause any condition imposed by New

York law can be found in the books," it was appropriate to find that by accepting a New York choice of law provision, petitioners had "knowingly" surrendered any right to recover punitive damages. *Mastrobuono,* 20 F.3d at 717; Pet. App., p. 14. Such a conclusion is, however, clearly untenable.

Moreover, the Seventh Circuit's decision in this regard directly conflicts with the decision of the Eleventh Circuit in *Bonar, supra*. In *Bonar*, the Eleventh Circuit flatly rejected the argument that the plaintiffs had waived their right to recover punitive damages by signing a customer agreement requiring arbitration of all disputes and a New York choice of law provision. *Bonar*, 835 F.2d at 1387-1388. The Seventh Circuit's incorrect application of the law of waiver, as well

as the conflict between the decision of the Seventh Circuit in this case and the Eleventh Circuit in *Bonar*, further supports the granting of *certiorari*.

CONCLUSION

For the foregoing reasons, the Petition For Writ Of Certiorari should be granted.

Respectfully submitted,

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APPENDIX

In the

United States Court of Appeals

For the Seventh Circuit

No. 93-3647

AHMAD BARAVATI,

Plaintiff-Appellee,

v.

JOSEPHTHAL, LYON & ROSS, INCORPORATED, and PETER SHEIB,

Defendants-Appellants.

Appeal from the United States District Court
for the Northern District of Illinois, Eastern Division.
No. 93 C 338—**George M. Marovich,** *Judge.*

ARGUED APRIL 7, 1994—DECIDED JULY 1, 1994

Before POSNER, *Chief Judge*, BAUER, *Circuit Judge*, and TINDER, *District Judge.**

POSNER, *Chief Judge.* Ahmad Baravati was employed as a broker in the Chicago office of Josephthal, Lyon & Ross, Inc. (JLR), a New York securities firm that is a member of the National Association of Securities Dealers. JLR fired Baravati. The NASD requires that whenever a broker is terminated, the member firm that employed him must fill out and submit to the association a termina-

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* Hon. John Daniel Tinder of the Southern District of Indiana.

tion notice form (form U-5), which the NASD retains and makes available to any member who wants information about the broker, perhaps because he has applied for a job with the member. The form asks the reason for the termination. The reason JLR listed was that Baravati was "under investigation by [JLR] for the fraudulent and wrongful taking of firm property in the amount of $7,650.25." The parties agree that Baravati's contract with JLR required disputes, tortious as well as contractual, arising under the contract to be arbitrated in accordance with the NASD's Code of Arbitration Procedure. (Submission of disputes to arbitration is now a required term in employment contracts with members of NASD. *Kresock v. Bankers Trust Co.*, 21 F.3d 176, 178-79 (7th Cir. 1994).) Contending that the reason stated in the U-5 for firing him was false and defamatory—that in fact he had been fired in retaliation for blowing the whistle to the SEC about fraud committed by JLR on its customers—Baravati, like a number of similarly situated brokers lately (see Edward Felsenthal, "Filings about Brokers' Departures Made by Firms Spark Libel Suits," *Wall St. J.*, April 14, 1994, p. B2), invoked the arbitral process. The arbitrators found that he had been defamed and awarded him $60,000 in compensatory damages and $120,000 in punitive damages. Baravati went to district court to enforce the award, 9 U.S.C. § 9, and won. 834 F. Supp. 1023 (N.D. Ill. 1993). JLR appeals.

Judicial review of arbitration awards is tightly limited; perhaps it ought not be called "review" at all. By including an arbitration clause in their contract the parties agree to submit disputes arising out of the contract to a nonjudicial forum, and we do not allow the disappointed party to bring his dispute into court by the back door, arguing that he is entitled to appellate review of the arbitrators' decision. *United Paperworkers International Union v. Misco, Inc.*, 484 U.S. 29, 36 (1987); *Chicago Typographical Union v. Chicago Sun-Times, Inc.*, 935 F.2d 1501, 1504-06 (7th Cir. 1991); *Brotherhood of Locomotive Engineers v. Atchison, Topeka & Santa Fe Ry.*, 768 F.2d 914, 921 (7th

Cir. 1985). There are, nevertheless, limited grounds on which an arbitral award can be set aside, such as that the arbitrators "exceeded their powers." 9 U.S.C. § 10(a)(4).

A number of courts, including our own, have said that they can set aside arbitral awards if the arbitrators exhibited a "manifest disregard of the law." *Health Services Management Corp. v. Hughes*, 975 F.2d 1253, 1267 (7th Cir. 1992); *Todd Shipyards Corp. v. Cunard Line, Ltd.*, 943 F.2d 1056, 1060 (9th Cir. 1991); Note, "Vacatur of Commercial Arbitration Awards in Federal Court: Contemplating the Use and Utility of the 'Manifest Disregard' of the Law Standard," 27 *Ind. L. Rev.* 241, 251-54 (1993). Two courts, however, have declined to adopt this formula, *Ainsworth v. Skurnick*, 960 F.2d 939, 940-41 (11th Cir. 1992) (per curiam); *Stroh Container Co. v. Delphi Industries, Inc.*, 783 F.2d 743, 750 (8th Cir. 1986), though without rejecting it. Two have criticized it. *Raiford v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 903 F.2d 1410, 1412-13 (11th Cir. 1990); *I/S Stavborg v. National Metal Converters, Inc.*, 500 F.2d 424, 430-31 (2d Cir. 1974). The criticisms are marshaled and endorsed in the excellent student note in the *Indiana Law Review*. The formula is dictum, as no one has found a case where, had it not been intoned, the result would have been different. It originated in *Wilko v. Swan*, 346 U.S. 427, 436-37 (1953) (see *Drayer v. Krasner*, 572 F.2d 348, 352 (2d Cir. 1978) (Friendly, J.))—a case the Supreme Court first criticized for its mistrust of arbitration and confined to its narrowest possible holding, *Shearson/American Express Inc. v. McMahon*, 482 U.S. 220, 231-34 (1987), and then overruled. *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477, 485 (1989). Created *ex nihilo* to be a nonstatutory ground for setting aside arbitral awards, the *Wilko* formula reflects precisely that mistrust of arbitration for which the Court in its two *Shearson/American* opinions criticized *Wilko*. We can understand neither the need for the formula nor the role that it plays in judicial review of arbitration (we suspect none—that it is just words). If it is meant to smuggle review for clear error in by the back door, it is inconsistent with the entire modern law of arbitration. If it is in-

tended to be synonymous with the statutory formula that it most nearly resembles—whether the arbitrators "exceeded their powers"—it is superfluous and confusing. There is enough confusion in the law. The grounds for setting aside arbitration awards are exhaustively stated in the statute. Now that *Wilko* is history, there is no reason to continue to echo its gratuitous attempt at nonstatutory supplementation. So it will be enough in this case to consider whether the arbitrators exceeded their powers.

JLR makes two points (the third, that Baravati waived his right to complain about being defamed, is frivolous and need not be discussed). The first is that under the law of Illinois the contents of the U-5 form that JLR filled out and submitted to the NASD are, like a pleading, testimony, exhibit, or opinion, absolutely privileged as a communication made in a judicial or quasi-judicial proceeding. The law of *Illinois*? Confirmation of the arbitrators' award was sought under Title 9 of the U.S. Code, the Federal Arbitration Act. Yet one might think that in a case such as this, where the basis of federal jurisdiction is diversity of citizenship rather than the existence of a federal question (as it would be if, for example, an arbitration award based on a collective bargaining contract subject to section 301 of the Taft-Hartley Act, 29 U.S.C. § 185, were sought to be enforced), substantial constitutional questions would arise if the federal courts tried to create a body of substantive law to be applied by the arbitrators. *Erie R.R. v. Tompkins*, 304 U.S. 64 (1938), holds that the conferral by Article III of the Constitution of diversity jurisdiction on the federal courts does not authorize them to create substantive law to govern the disputes arising under that jurisdiction. The Federal Arbitration Act, however, is limited to diversity cases *that affect interstate commerce*, 9 U.S.C. §§ 1, 2, a basis of federal lawmaking jurisdiction. *Bernhardt v. Polygraphic Co.*, 350 U.S. 198, 201-02 (1956); *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 405 (1967). The Act therefore can, and the Supreme Court has held that it does, authorize the federal courts

to create a federal substantive law of arbitration to apply in cases under the Act. *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*, 460 U.S. 1, 24-25 and n. 32 (1983); *Southland Corp. v. Keating*, 465 U.S. 1, 11-16 (1984).

A standard way in which federal courts make federal common law is by adopting the law of the state whose law would govern in the absence of federal law, subject to the implicit proviso that the adopted state law be consistent with federal policy. The states have richer bodies of common law than the federal courts do and it is desirable to minimize the number of different legal rules to which people are subject. *Powers v. United States Postal Service*, 671 F.2d 1041 (7th Cir. 1982). So if we started with federal common law we might end up with Illinois law after all. But there is a more direct route. This case is unusual because the arbitrators, rather than being called upon to interpret a contract, their usual function, were called upon to determine whether one party had defamed the other. (There is, as we said, no contention that they were not empowered by the parties' contract to do so.) Defamation is an area of state law, and the various defamation privileges are an integral part of the law of defamation. It would be surprising if in authorizing the arbitration of their disputes the parties had intended the arbitrators to *make up* a law of defamation to apply to those disputes. More likely they were expected to apply the defamation law of some state, and Illinois is as plausible a candidate as any, since Baravati worked in JLR's Chicago office. So let us apply the Illinois law of privilege.

That is easier said than done. *Fahnestock & Co. v. Waltman*, 935 F.2d 512, 516-17 (2d Cir. 1991), rejected a claim of privilege on facts similar to ours, but it was not an Illinois case—there is no Illinois case on the question—and the court's brief discussion suggests that the arbitrators were correctly applying New York law. It might seem obvious and therefore in need of no authority that

arbitrators may not disregard established legal privileges and immunities. Privileges and immunities limit the powers of adjudicative bodies because of concerns believed to override the interest in allowing such bodies to consider all probative evidence and render decisions that vindicate the rights of injured parties. The absolute privilege from liability for defamation based on judicial and quasi-judicial communications is closely related to the absolute immunity of judges, legislatures, prosecutors, and witnesses; in fact it overlaps all those immunities. *Briscoe v. LaHue*, 460 U.S. 325, 330-36 (1983). Without it the collection and examination of evidence would be hampered, because lawyers, litigants, witnesses, and judges would be fearful of being sued for defamation on the basis of their submissions, arguments, testimony, or rulings. The absolute privilege is recognized in Illinois, *McGrew v. Heinold Commodities, Inc.*, 497 N.E.2d 424, 432 (Ill. App. 1986), and was extended to quasi-judicial bodies in *Allen v. Ali*, 435 N.E.2d 167 (Ill. App. 1982), which involved the state supreme court's attorney disciplinary body. And yet it is far from plain that to allow arbitrators, alone of dispute resolvers, to disregard the privilege would undermine it. The privilege is, we may assume, waivable (other privileges are, and we cannot see why this one should be an exception, though we can find no cases on the question), and consent to arbitration could be thought a waiver if it is the practice of arbitrators not to honor the absolute privilege. The parties have not told us whether it is or not.

We need not wrestle this issue to the ground. JLR could not in any event assert the absolute privilege under the facts of this case. This is true even though federal securities law gives NASD quasi-judicial responsibilities. Those laws impose duties of self-regulation on stock exchanges and on, what is functionally the same thing, dealer associations in the over-the-counter markets. 15 U.S.C. § 78o-3; *SEC v. Waco Financial, Inc.*, 751 F.2d 831, 832 (6th Cir. 1985); Louis Loss, *Fundamentals of Securities Regulation* 620-24 (2d ed. 1988). We may assume that when the NASD

in the discharge of these duties investigates or adjudicates or imposes sanctions with respect to suspected violations of the rules that it enforces, the participants in those proceedings are entitled to the absolute privilege to the same extent as in judicial proceedings. Cf. *Kalish v. Illinois Education Ass'n*, 510 N.E.2d 1103 (Ill. App. 1987). But the submission of a U-5 form and its transmission (upon request) to members of the NASD are not stages in the association's quasi-judicial regulatory process. In the first instance they are the means which the NASD administers an employment clearinghouse. By revealing the reason for the termination the form gives other members of the association potentially valuable information concerning the availability and suitability of potential employees. This information service is remote from a judicial proceeding; and while a U-5 can trigger an investigation or even serve as evidence in a disciplinary proceeding against a member or broker, any item of information could do that. To insulate the members from liability for the contents of their U-5s would be tantamount to allowing a member of the NASD to blackball a former employee from employment throughout the large sector of the industry that the membership of the association constitutes. (About half of all registered broker-dealers belong to it.)

We must not overdramatize. The employee can seek to clear his name by asking the NASD to investigate or by invoking the arbitral process, as Baravati did; in fact, the defendants told us without contradiction, Baravati found employment with another member firm; and securities firms will be reluctant to give reasons for a termination that might scare their clients, although we do not know to what extent U-5s circulate outside the brokerage houses themselves. So the sky would not fall if the privilege were allowed to bar the kind of relief sought by Baravati. What is more, since the members are *required* to state the reason for termination on the U-5, denial of the privilege puts them in a hard place, where if they state a reason discreditable to the employee they may be sued for libel while if they lie about the reason they will be

violating the association's rules. *NASD Manual* ¶ 1153 (C.C.H. 1993) (art. IV, § 3(a) of NASD's by-laws). But it is only the *absolute* privilege that is in issue in this case. All concede that, just as in the case of an employer's character reference, the firm has a qualified privilege to defame the employee on the U-5, a privilege forfeited (under Illinois law) only if the firm knows or is reckless in failing to discover that it is defaming him falsely. *Mittelman v. Witous*, 552 N.E.2d 973, 980-81 (Ill. 1989). An absolute privilege is strong medicine, and we do not think that JLR has made a case for extending it beyond the judicial and quasi-judicial context and into the termination notice, even if the privilege is not waived in advance by consent to have disputes resolved by arbitrators rather than by courts.

JLR's second argument is that the arbitrators exceeded their powers in awarding punitive damages. NASD's Code of Arbitration Procedure, incorporated by reference in the contract between Baravati and JLR, requires arbitrators to provide "a summary of . . . the damages and other relief awarded," but contains no other reference to the arbitrators' remedial powers. *Mastrobuono v. Shearson Lehman Hutton Inc.*, 20 F.3d 713 (7th Cir. 1994), holds that if the body of law that the parties agreed would govern their disputes forbids arbitral awards of punitive damages in that class of case, a federal court cannot confirm the award. The contract specified New York law, which forbade arbitral awards of punitive damages in the type of dispute that had arisen and had been submitted to arbitration, so we held that the arbitrators' award of punitive damages could not be confirmed.

Mastrobuono put us in conflict with four other circuits, which hold that such a choice of law designation does not override the power of arbitrators to award punitive damages, provided the rules that the parties have agreed are to govern the arbitration authorize the arbitrator, implicitly or explicitly, to award such damages. *Bonar v. Dean Witter Reynolds, Inc.*, 835 F.2d 1378, 1387 (11th Cir. 1988); *Raytheon Co. v. Automated Business Systems, Inc.*, 882 F.2d 6 (1st Cir. 1989); *Todd Shipyards Corp. v. Cunard Line, Ltd.*, *supra*, 943 F.2d at 1061-63; *Lee v. Chica*, 983 F.2d 883, 887-88 (8th Cir. 1993); see also *J. Alexander Securities, Inc. v. Mendez*, 21 Cal. Rptr. 2d 826 (App. 1993), and Justice O'Connor's dissent from the denial of certiorari in *Mendez*, 62 U.S.L.W. 3575 (U.S. June 6, 1994). The rules of the American Arbitration Association, which were applicable in those cases, authorize arbitrators to award "any remedy which [is] just and equitable and within the scope of the agreement," and this was deemed authorization enough for the awarding of punitive damages. These courts, however, would enforce a provision in an arbitration clause that *forbade* the arbitrator to award punitive damages; and if, as we thought was the situation in *Mastrobuono*, the parties do the same thing by invoking a body of law that contains such a prohibition, there would be no greater reason to refuse to honor their choice. Indeed, short of authorizing trial by battle or ordeal or, more doubtfully, by a panel of three monkeys, parties can stipulate to whatever procedures they want to govern the arbitration of their disputes; parties are as free to specify idiosyncratic terms of arbitration as they are to specify any other terms in their contract. Cf. *Rashid v. Schenck Construction Co.*, 438 S.E.2d 543, 547 (W. Va. 1993); *Perini Corp. v. Greate Bay Hotel & Casino, Inc.*, 610 A.2d 364, 369 (N.J. 1992), overruled on other grounds in *Tretina Printing, Inc. v. Fitzpatrick & Associates, Inc.*, 640 A.2d 788 (N.J. 1994); *Astoria Medical Group v. Health Ins. Plan*, 182 N.E.2d 85, 87 (N.Y. 1962). For that matter, parties to adjudication have considerable power to vary the normal procedures, *DDI Seamless Cylinder Int'l, Inc. v. General Fire Extinguisher Corp.*, 14 F.3d 1163 (7th Cir. 1994), and surely can stipulate that punitive damages will not be awarded. The difference between *Mastrobuono* and the contrary decisions is simply a difference over the proper interpretation of the choice of law clause read in light of the parties' agreement to have their disputes arbitrated under rules that allow for the award of punitive damages. The other circuits believe that these provisions are best reconciled by confining the choice of law provision to sub-

stantive matters, allowing the arbitrators free rein in procedural and remedial matters.

This disagreement does not bear directly on the present case, however, where there is neither a choice of law provision nor a provision in the governing arbitration rules concerning the scope of the arbitrators' remedial powers. We have suggested that if the court asked to enforce (or set aside) the arbitrators' award had occasion to apply federal common law to some dispute (say over arbitrability), it might well look to Illinois law for guidance. That is a different question from whether the *arbitrators* were required to look to Illinois law for guidance or remedies. The contract involved in the *Mastrobuono* case *told* the arbitrators to apply New York law, and the question was whether this meant remedial (as we thought, and the other circuits do not) as well as substantive law. There is no similar directive in this case. We hesitate to infer one. It is commonplace to leave the arbitrators pretty much at large in the formulation of remedies, just as in the formulation of the principles of contract interpretation. *United Steelworkers v. Enterprise Wheel & Car Corp.*, 363 U.S. 593, 597 (1960); *Miller Brewing Co. v. Brewery Workers*, 739 F.2d 1159, 1163 (7th Cir. 1984); *Chameleon Dental Products, Inc. v. Jackson*, 925 F.2d 223, 225 (7th Cir. 1991); *Willoughby Roofing & Supply Co. v. Kajima International, Inc.*, 776 F.2d 269 (11th Cir. 1985) (per curiam). So far as appears, that is what the parties intended here. No negative inference can be drawn from the failure of the NASD's Code of Arbitration Procedure to say anything about the scope of the arbitrators' powers. Silence implies—given the tradition of allowing arbitrators flexible remedial discretion—the absence of categorical limitations. Since that is the norm, we assume that the parties would have said something in the arbitration clause had they wanted to depart from it.

Occasional statements that punitive damages are disfavored in arbitration, see, e.g., *Miller Brewing Co. v. Brewery Workers*, *supra*, 739 F.2d at 1164, must be read in context. Most arbitrations concern contract interpretation, and it is untraditional and still infrequent to award

punitive damages for breach of contract. "[T]he traditional unavailability of punitive or exemplary damages in arbitration . . . can be traced to the common law notion that punitive damages are not available in the standard action for breach of contract." Marvin F. Hill, Jr. & Anthony V. Sinicropi, *Remedies in Arbitration* 436 (2d ed. 1991). Here we have the unusual case of a tort arbitration, and punitive damages are commonly awarded for certain torts, including defamation subject to constitutional limitations not here invoked.

It remains to consider whether Illinois has a policy limiting the award of punitive damages by arbitrators that we should adopt as part of the federal common law of arbitration applicable to disputes that would be governed by Illinois law were they not within the purview of the Federal Arbitration Act. *Fahnestock & Co. v. Waltman*, *supra*, held that New York's common law rule forbidding arbitrators to award punitive damages governed in an arbitration under the Federal Arbitration Act when, as in the present case, the arbitration was not being conducted under rules authorizing such relief. There was no question that that *was* New York's rule. We have only one Illinois decision, *Edward Electric Co. v. Automation, Inc.*, 593 N.E.2d 833, 842-43 (Ill. App. 1992); it is based entirely on the New York rule; and it has been narrowly interpreted in the only case to cite it. *Board of Education v. Illinois Educational Labor Relations Board*, 617 N.E.2d 269, 277 n. 4 (Ill. App. 1993). *Edward* holds that arbitrators may not award punitive damages unless the contract authorizing arbitration expressly authorizes such awards. It did not do so here. *Edward* is a contract case, not a tort case, and we cannot be certain that the outcome would have been the same had it been a case in which punitive damages would have been a normal remedy for a court to award; for if a court, why not a panel of arbitrators, if that was the parties' own preferred tribunal? More fundamentally, we do not think that a state policy based, as the rule announced in the *Edward* decision is, on mistrust of arbitrators is a plausible candidate for incorporation

into the federal common law of arbitration. The Federal Arbitration Act proceeds on the opposite premise, as the *Shearson/American* cases make clear. Close questions concerning the interpretation of the scope of the powers authorized to the arbitrator are resolved in favor of those powers. That is the teaching of the anti-*Mastrobuono* cases that we cited earlier, and the disagreement between those cases and *Mastrobuono* is not over the principle but over its application. Even if *Edward* is a correct statement of Illinois law, it is not a correct interpretation of the Federal Arbitration Act. In arbitrations governed by that Act, arbitrators are authorized to award punitive damages unless the parties have withdrawn that power, which they have not done here. *J. Alexander Securities, Inc. v. Mendez, supra*, 21 Cal. Rptr. 2d at 831.

Although *Fahnestock* is distinguishable from the present case, we will not coyly attempt to conceal our disagreement with it. Not only is a rule forbidding arbitrators to award punitive damages an implausible candidate for incorporation into the federal common law of arbitration, but *Fahnestock* appears to hold that state common law of arbitration governs cases under the Federal Arbitration Act unless the parties have expressed their intentions not to be bound by it, as by subscribing to rules of arbitration that authorize the award of relief barred by the common law. At that point, the court seems to have thought, federal common law would spring back into place. We don't agree. State common law hostile to arbitration is preempted by federal common law friendly to it.

Of course if the Illinois law of *defamation* did not authorize the award of punitive damages in a case such as this, the arbitrators would be bound if we are correct that the parties' agreement was that the arbitrators would apply the law of some state, plausibly Illinois's, to tort claims arising out of the employment relation. That is not argued. The argument is that Illinois has some special rule concerning the award of punitive damages by arbitrators

in any class of case. Such a rule, if it exists, is preempted by the Federal Arbitration Act.

The arbitrators' award was lawful, and the judgment of the district court is therefore

AFFIRMED.

A true Copy:

Teste:

Clerk of the United States Court of Appeals for the Seventh Circuit